

**REPORT TO THE
SUB-COMMITTEE ON TAX POLICY ISSUES
COMMITTEE ON APPROPRIATIONS AND REVENUE
KENTUCKY GENERAL ASSEMBLY**

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The public services offered by Kentucky state government and the tax structure used to finance these services reflect the values and priorities of Kentuckians. They evidence the importance placed on investments in the state's future through education, infrastructure and other key services. They indicate the priority placed on families and on business competitiveness.

The tax system is a particularly important aspect of the overall government structure because it transfers incomes and resources from private individuals and businesses into the public sector. Sufficient resources must be shifted to ensure that vital services are adequately financed, but in ways that encourage the success of businesses in Kentucky and the best future for Kentucky's citizens. The approach should be to design a right-sized government and an appropriate financing structure that together allow the economy to achieve its greatest potential and the burden of taxes to be fairly shared by the state's businesses and citizens.

This report is a discussion of the key issues related to the Kentucky tax structure that were selected for deliberation by the Sub-Committee on Tax Policy Issues. The issues are all essential concerns about the tax structure, but neither the deliberations nor this report is an attempt to provide a comprehensive evaluation of the Kentucky structure. These issues were carefully selected because of their known policy relevance to Kentucky today.

The report begins with a discussion of basic characteristics of Kentucky's tax system, and how it compares with that selected by other states. This discussion is followed by an examination of issues related to three vital topics:

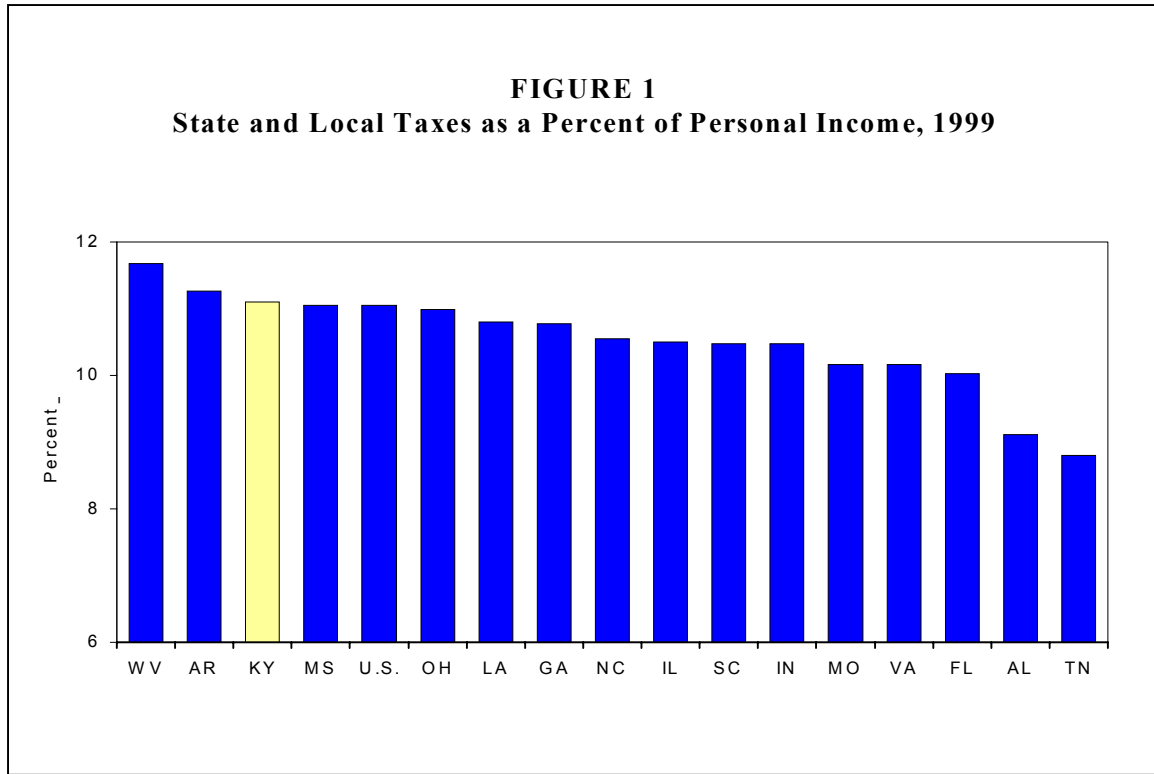
¹ The author thanks the Co-Chairs of the Sub-Committee, Representative Harry Moberly and Senator Richie Sanders, and other members of the Sub-Committee for their direction and counsel. The author is deeply indebted to Terry Jones of the Legislative Research Commission for his numerous suggestions, advice and insights. Finally, the author expresses his profound gratitude to many members of Kentucky State government who graciously shared their time, information, and views on many of the issues discussed in this report.

- How the tax structure performs in financing state government
- How the tax structure affects families
- How the tax structure affects business competitiveness.

The report closes with a listing of policy options that was derived from the Sub-Committee meetings.

I. CHARACTERISTICS OF THE KENTUCKY TAX STRUCTURE

The share of Kentucky personal income paid in state and local taxes (11.10 percent) is slightly above the national average (11.05 percent) and is in the upper half of neighboring and southeastern states (see Figure 1).² Nonetheless, the per person taxes (Figure 2) paid in Kentucky (\$2464) are lower than the national norm (\$2992). Thus, the amount of tax dollars that is available to finance essential public services is lower than in the average of the U.S. This means that Kentucky must try harder than many other states if it is to finance similar amounts of investment in education and infrastructure.



Kentucky state government's tax structure is very similar to that in other states, but Kentucky local governments have a very different structure from other local governments. Overall, this leaves the combined Kentucky structure having a distinctive appearance. Kentucky state and local governments rely much more heavily on the taxation of individual income than the norm around the U.S. (Figure 3). Kentucky generates 33.0 percent of revenues from taxation of income versus only 23.2 percent in the average state. This results because of the importance that the personal income tax plays at the state level (which is about the same reliance as the national norm) and the occupational privilege tax plays at the local level (which is well above the national norm for local governments).³

² Cross-state comparisons of tax burdens are best made by examining the combination of state and local governments because of the widely differing roles that state versus local governments play in the delivery of public services.

³ Local governments in only 13 states collect income tax revenue.

FIGURE 2
State and Local Taxes Per Capita, 1999

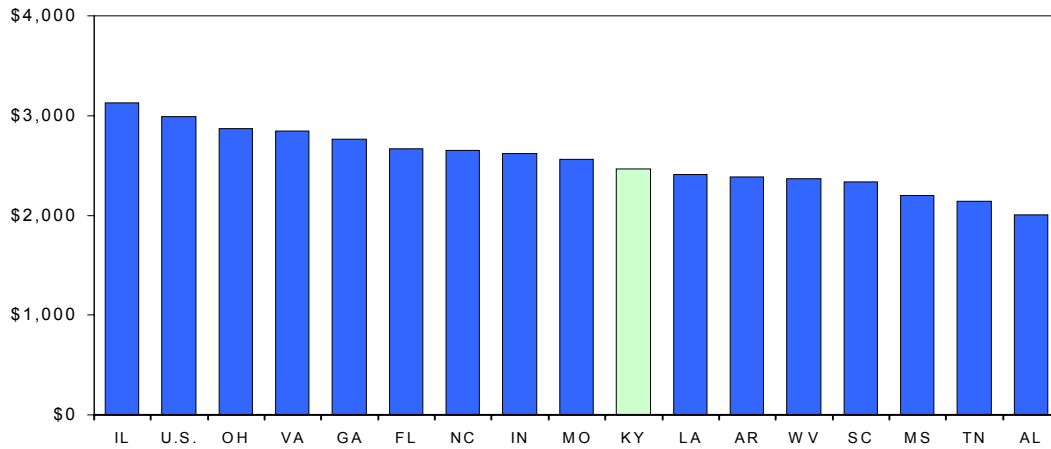
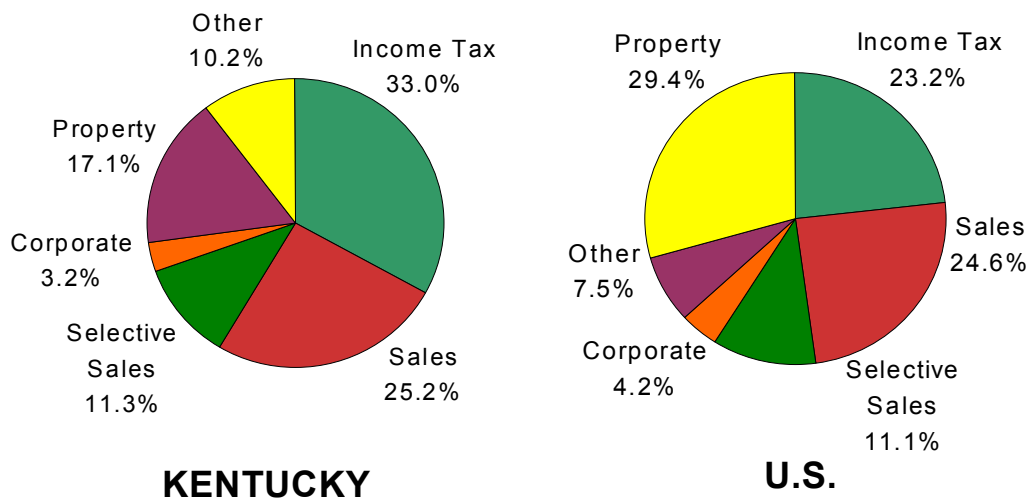


FIGURE 3
Distribution of State and Local Tax Collections, Kentucky vs. U.S., 1999



The property tax plays a relatively small role in raising revenues in Kentucky, contributing only 17.1 percent of tax revenue versus 29.4 percent for the nation as a whole. Property taxes are particularly low for Kentucky local governments compared with local governments in other states. Heavy reliance on the occupational privilege tax, the somewhat greater role that transfers from the state⁴ play in Kentucky, and the smaller role that local governments play in service delivery in Kentucky⁵ allow for a smaller contribution from the local property tax. Kentucky state government collects a higher share from the property tax (5.1 percent) than the average of other states (2.0 percent) since many state governments do not levy property taxes. The property tax's relative contribution has been falling in Kentucky over the past 35 years, at least in part because of the limitations on property tax revenue growth that are imposed by H.B. 44.

General sales taxes generate a slightly larger share of revenue than in the average state even though Kentucky local governments are unable to levy sales taxes while local governments in 34 states levy such taxes.⁶ The Kentucky state sales tax rate (6.0 percent) is above the national median of 5.0 percent, and the state share collected from sales taxes is above the national average. The selective sales taxes, cigarette, alcohol and fuel taxes, are also relatively low in Kentucky, mostly because Kentucky's tax rates for each of these selective commodities are below national norms.

As already noted, the Kentucky state tax structure is similar to the U.S. average (Figure 4). The roles of the personal income and the general sales taxes are very similar to the U.S. average. The primary differences in the state tax structure are Kentucky's greater reliance on property taxes and lower reliance on selective sales taxes and corporate taxes. The small contribution of corporate taxes occurs despite Kentucky imposing an 8.25 percent rate versus the median state's 6 percent rate and Kentucky imposing the corporate license tax.

Kentucky state government raises a much larger share of the combined state/local tax structure than in the average state (75.4 percent versus 61.3 percent), and more than most neighboring or southeastern states (Figure 5). State government is also responsible for more of the combined state/local government spending (see footnote 4). Kentucky local governments have a dramatically different revenue structure from the average state, relying much less on the property tax and much more on occupational privilege taxes than the average state (see Figure 6).

⁴ In 1999, Kentucky local governments received 38.0 percent of their general revenues from state transfers versus 35.3 percent in the average state.

⁵ In 1999, Kentucky state government was responsible for 56.5 percent of direct state/local expenditures versus 42.7 percent for the average state.

⁶ For comparison with other states, the Kentucky sales tax and the motor vehicle usage taxes are added together in Figure 3, since most states tax motor vehicle sales within their sales tax.

FIGURE 4
Distribution of State Tax Collections, Kentucky vs. U.S., 2000

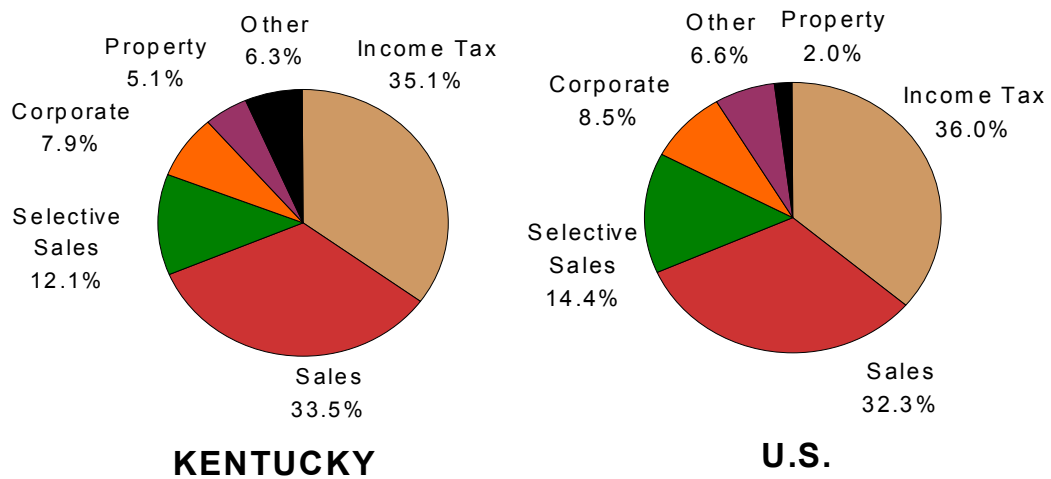


FIGURE 5
State Share of State and Local Taxes, 1999

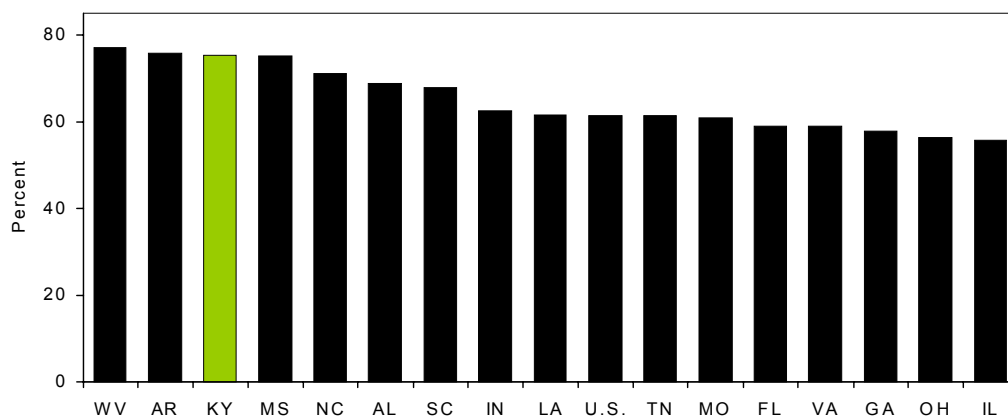
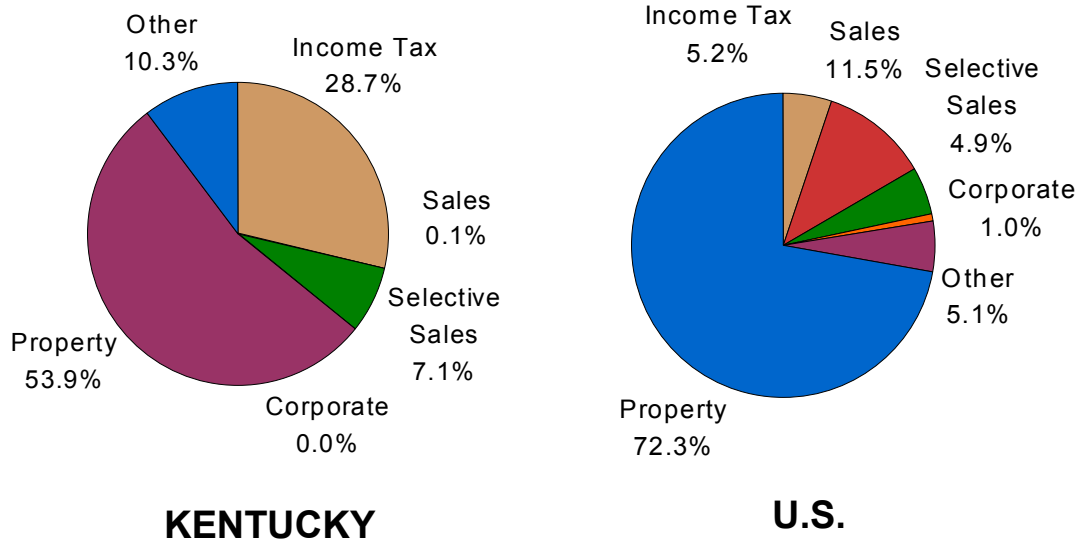


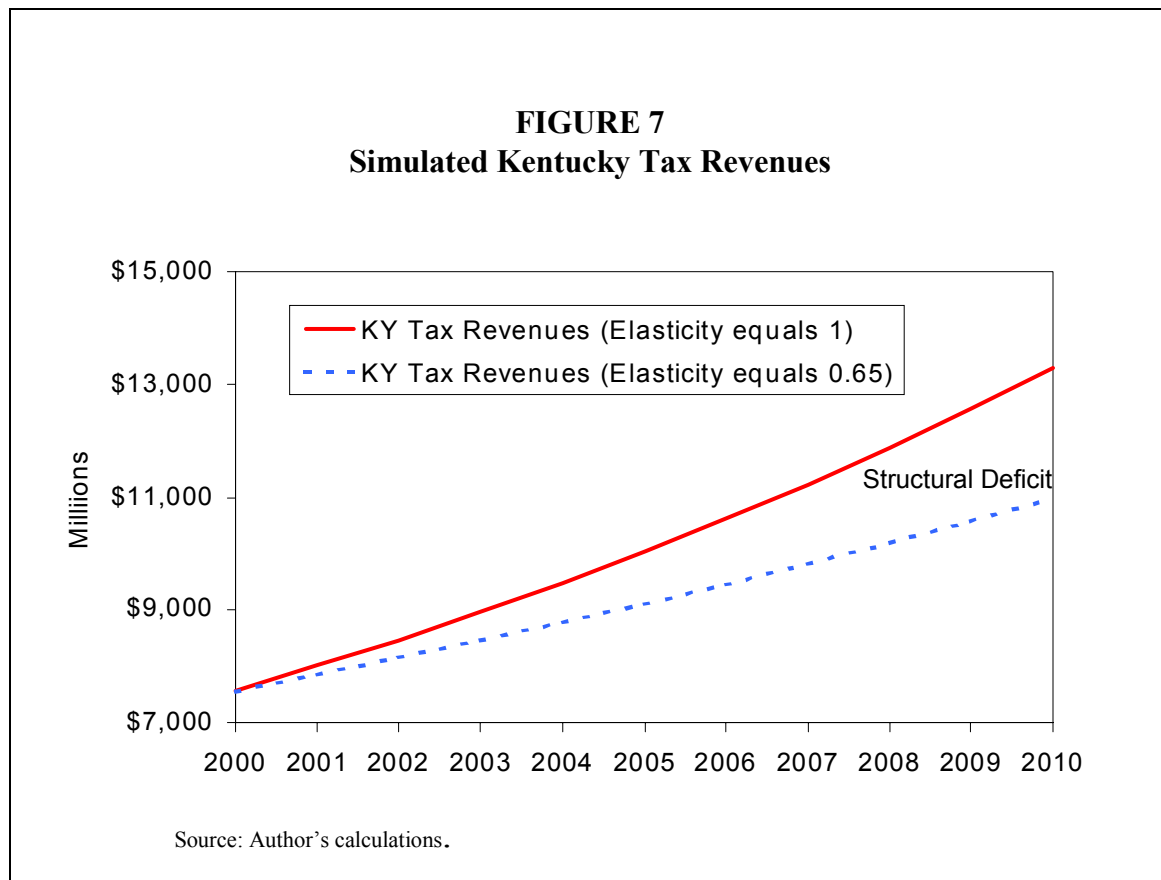
FIGURE 6
Distribution of Local Tax Collections, Kentucky vs. U.S., 1999



II. PERFORMANCE OF THE TAX SYSTEM IN FINANCING KENTUCKY GOVERNMENT

Kentucky's Structural Deficit

Revenue growth in Kentucky has slowed dramatically over the past six years, suggesting that the Commonwealth faces a structural deficit. Revenue growth between 1995 and 2001 was much lower than during the previous seven years and increased only about two-thirds as fast as the state's economy. Expenditures, on the other hand, can be expected to grow at about the same rate as the economy. Continuation of the very slow revenue growth through 2010 means that state government would fall from 7.7 to 6.5 percent of the state's economy, a huge decline in the Commonwealth's ability to finance education and infrastructure investments in its future. By 2010, revenues would be more than \$2.3 billion short of the demand for public services (see Figure 7).



The huge shortfall can be financed with variations on three basic approaches. First, the size of state government can be allowed to fall. Second, higher rates could be legislated. For example, sales and income tax rates could be increased, but large hikes would be necessary. The sales and income tax rates would both need to be increased 27.3 percent (for example, the new sales tax rate would need to be 7.64 percent) to finance the shortfall. Third, the elasticity can be increased so that revenues will grow more rapidly.

This option, which means lower rates, broader tax bases, and stronger natural growth in tax revenues, is much preferred as a general rule.

Sufficient Revenue Growth

The Kentucky revenue system must provide sufficient revenues to finance the services that are essential to a high quality of life and to investment in the economic future of the Commonwealth and its residents and businesses. There are three aspects to adequately financing government: 1) revenues must finance the appropriate size of government based on the tastes and values of the citizens, 2) the structure must allow for acceptable funding across the business cycle, and 3) the revenue structure must allow financing to grow with the needs of the state so that the appropriate size government can be maintained over time. Consideration of the right size of government and the ability of the tax system to perform in economic recessions as well as expansions are very important issues, but are not addressed in detail here. The focus is on the ability of the tax system to provide sufficient revenues over the long term, because this is the key issue faced by Kentucky today.

An appropriate pattern of revenue growth does not just happen; it is the result of careful design of tax policy. Policy is best set by determining the correct size of government and then setting the revenue structure to grow over time at approximately the same rate as the state's personal income without the need to increase rates. This permits the desired size of government to be maintained in the future and allows state government tax financing to remain a fixed percentage of the state's economy. Then, tax rates should be decreased whenever an explicit decision is made to reduce the size of government and should be increased only when an explicit decision is made to increase the size of government.⁷ This is not to suggest that revenues will grow as fast as the economy every year. It is nearly impossible to design a recession proof tax system because nearly all taxes are ultimately levied on economic activity that is slowing in a recession. In recession years, such as fiscal 1990 and fiscal 2002, revenues can be expected to rise more slowly than income, but this should be offset by better revenue growth in expansion years, resulting in a system with the appropriate growth path. A rainy day fund can be used to smooth out the pattern of expenditures over the business cycle.

Adequate revenue growth is achieved by adopting the proper balance of revenue instruments. The more rapidly growing personal income tax must be balanced with the more moderately growing sales tax and the slow growing selective sales taxes to achieve the intended growth relationship with the economy. The required balance will depend on specific characteristics of the tax structure. For example, income taxes will generally grow faster relative to the economy when the structure is more progressive and sales taxes will grow more rapidly when broader taxation of services is adopted. Also, the balance of tax sources will need to vary with a state's economic structure, so there is no single tax system that fits all states.

⁷ The only other time a major tax change should be needed is if a major structural change occurs in the tax system. The current effect of electronic commerce on state tax structures, if unabated, is such a structural change.

Kentucky's Revenue Elasticity

Kentucky's revenue growth has performed in line with desired norms when the past 12 years are aggregated. The revenue elasticity⁸ for total receipts was 1.001 from 1988 through 2000,⁹ after adjustment for rate changes.¹⁰ However, the pattern of revenue growth is troubling. Kentucky's tax structure has often grown as rapidly as the economy on an annual basis. For example, tax revenues grew as fast as personal income in 10 of the 14 years between 1982 and 1995. However, revenues have failed to grow as fast as the economy in any of the six years since 1995 and will not grow as fast as the economy again in 2002. Overall, the revenue elasticity was 1.24 from 1988 to 1995, but fell to 0.65 from 1995 to 2000. The low elasticity during the second half of the 1990s is particularly surprising since it occurred during the years when the national economy was very robust and when most states were experiencing outstanding revenue growth.¹¹

Total state receipts declined from 8.48 percent of personal income in 1995 to 7.71 percent in 2000,¹² though there had been a pattern of rising revenues relative to the economy until 1995 (see Figure 8). Continuation of the post-1995 revenue pattern (a revenue elasticity of 0.65) will result in a further decline in state government as a share of the economy and could seriously impede Kentucky's ability to deliver quality education and other public services.

Simulation of Future Revenue Performance

The implications of the elasticity for the size of state government were simulated using two separate assumptions. First, revenues were assumed to grow at the same rate as the economy, which was the average revenue growth experience from 1988 through 2000 (adjusted for the sales tax rate increase). Second, revenues were assumed to grow at the same elasticity that occurred from 1995 through 2000. The latter is the most reasonable expectation for the next decade unless the problems causing the revenue elasticity to fall are resolved. In each scenario, Kentucky personal income is assumed to grow at the compound annual rate of 5.8 percent, the actual experience of 1988 through 2000.

The number of dollars collected by state government would grow under each scenario, as would the size of the Kentucky economy (see Table 1). But, the implications

⁸ The revenue elasticity is calculated as the percent change in revenues divided by the percent change in personal income. An elasticity of 1.0 means revenues grow at the same rate as the economy, an elasticity of less than 1.0 means revenues grow more slowly than the economy, and an elasticity of greater than 1.0 means revenues grow more rapidly than the economy.

⁹ The emphasis is on 1988 to 2000 because it represents an entire business cycle, including a recession and a long period of economic expansion.

¹⁰ The data were adjusted for the sales tax rate increase from 5 to 6 percent that occurred in 1991. No adjustment was made for changes to the income tax structure, some of which raised and some of which lowered (for example, exclusion of pension income) the income tax base.

¹¹ Revenue elasticities are not constant. They tend to rise in expansions and fall in recessions.

¹² Revenues decline as a share of personal income in years when the elasticity is less than 1.0.

for the state's ability to deliver services would be radically different under the two scenarios. The results evidence that state revenues would remain at 7.7 percent of the economy in 2010 under the first scenario (see Figure 9), with an elasticity of 1.0. Under this scenario, government would be maintained and the ability to invest in Kentucky's future would remain intact.

FIGURE 8
Kentucky Total Tax Collections as a Percent of Personal Income

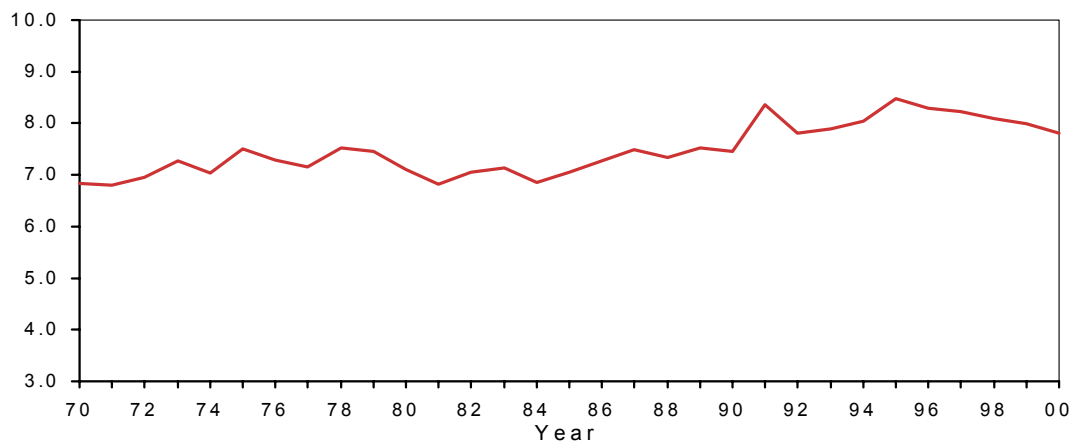
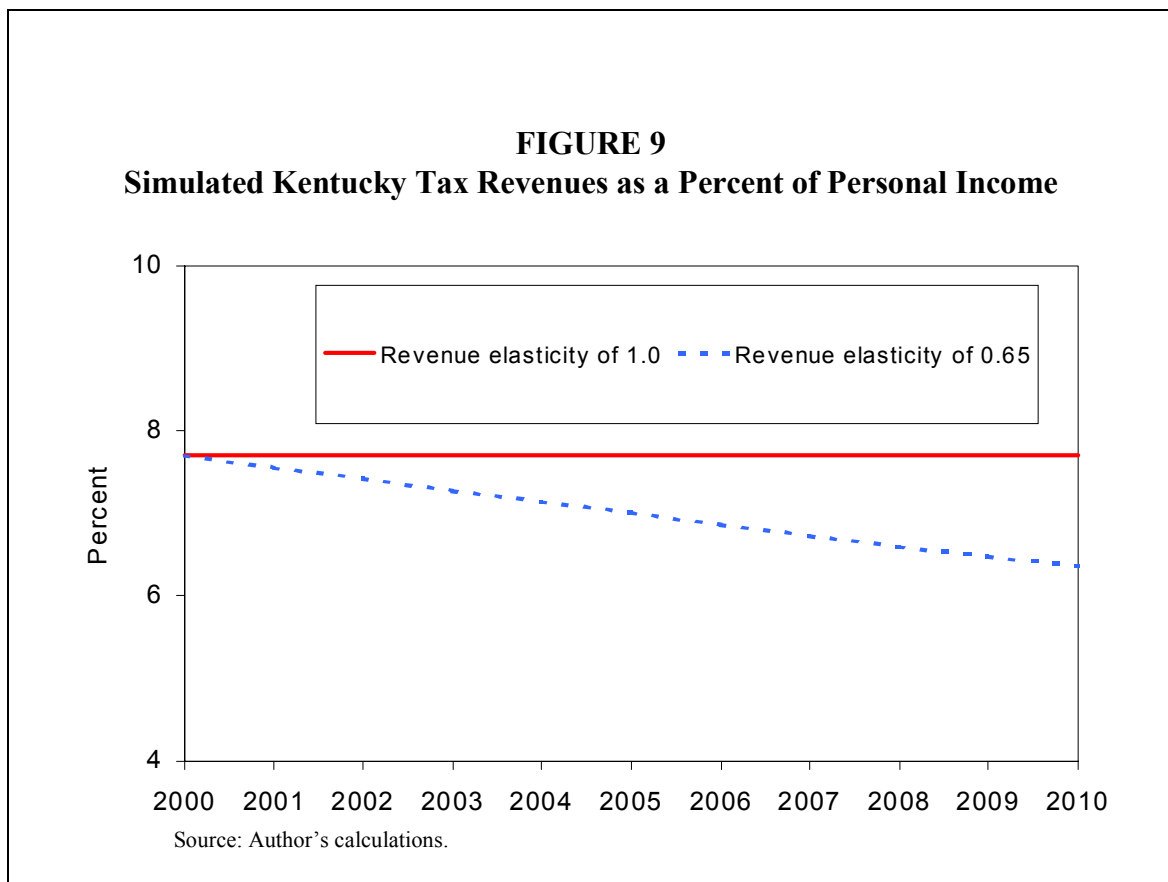


TABLE 1
Kentucky Revenue Simulation
(millions of current dollars)

Year	Revenue (Elasticity = 1.0)	Revenue (Elasticity = 0.65)	Shortfall
2002	\$8,472	\$8,154	\$318
2003	\$8,963	\$8,463	\$500
2004	\$9,482	\$8,784	\$698
2005	\$10,032	\$9,117	\$915
2006	\$10,613	\$9,462	\$1,151
2007	\$11,229	\$9,821	\$1,408
2008	\$11,879	\$10,193	\$1,686
2009	\$12,568	\$10,579	\$1,989
2010	\$13,296	\$10,980	\$2,316

Source: Author's calculations.

Revenues would decline to 6.5 percent of personal income during the next 9 years under the second scenario (see Figure 9), with an elasticity of 0.65. Revenues have not been lower than 6.8 percent of personal income during the past 30 years, so the size of state government would be dramatically reduced relative to recent history. The slower growth trend would result in \$2.3 billion less revenue (17.4 percent of 2010 revenues) in 2010 than would occur if revenue growth kept pace with economic growth (Figure 7). The revenue shortfall represents a structural deficit.¹³ These results illustrate that an appropriate revenue elasticity is the key for long-term finance of Kentucky state government.



Kentucky has three policy options for financing the structural deficit:

- Restructuring the revenue system to allow adequate revenue growth can eliminate the structural deficit.

¹³ The revenue shortfall is a structural deficit if the demand for public services grows at the same rate as personal income.

- Reducing the size of government can eliminate the structural deficit. This option reduces Kentucky's ability to deliver public services.
- The structural deficit can be financed with a series of rate increases. This is the strategy that was followed by Tennessee from 1970 through 1995. The option of raising rates means that government can be maintained as a constant share of personal income, but the simulation results evidence that large rate increases would be necessary. For example, income tax rates would need to be raised 47.0 percent (a maximum personal income tax rate of nearly 12 percent) to replace the revenue and maintain state revenues as a constant share of personal income. Sales tax rates would need to be raised 65.0 percent (the rate would need to rise from 6 to 9.9 percent) to replace the lost revenue. A proportionate combination of the two tax sources would require a 27.3 percent increase in the sales and income tax rates.

The option of reducing expenditure growth should be selected only if a determination is made that government is too large and an explicit decision is made to reduce the Commonwealth's investments in education and roads and expenditures on other public services. Otherwise, sound tax policy indicates that the preference should be for restructuring the revenue system so that natural growth in tax bases allows government to be maintained. This option is much preferred to a pattern of rate increases. Higher rates are politically difficult to enact and come in very discrete steps (resulting in fast revenue growth during the year when rates are increased and slower growth in other years) rather than the more continuous annual revenue growth that results from base increases (though the growth rates depend on the business cycle). Also, higher rates create negative implications for the economy that do not occur to nearly the same extent (though the growth rates still depend on the business cycle). For example, higher sales tax rates can encourage people to buy via e-commerce and can encourage people to travel to neighboring states to make purchases at lower tax rates, rather than buy from Kentucky merchants. Higher income tax rates encourage people to hide income and could result in some job losses to neighboring states. These changes in people's behavior are much more harmful to the Kentucky economy and Kentuckians' income than revenue increases from natural tax base rises.¹⁴

The Road Fund

A comprehensive evaluation of the road fund was not undertaken for this study, but the road fund's weak revenue growth suggests problems that are similar to those described above for all revenue. The road fund receives tax revenues from the motor fuels taxes, motor vehicle operator's license, motor vehicle registrations, motor vehicle usage tax, and motor vehicle rental usage tax. In fiscal 2001, the revenues were \$1013.1 million, a 4.0 percent decline from the previous year. Road fund tax revenues increased at

¹⁴ Economists have demonstrated that the negative consequences from taxation rise with the square of the tax rate, so high tax rates are particularly harmful.

a compound annual 3.5 percent from fiscal year 1992 to fiscal year 2001 evidencing an elasticity of .66. Thus, road fund tax revenues have been growing about two-thirds as fast as personal income. Despite the relatively weak revenue growth, road program expenditures have been maintained by shifting the mechanism used to account for road projects. The benefits that the new accounting approach permits in terms of additional road projects are expected to be exhausted in two years. At that point, the road program will either need to be reduced or tax rates increased. It is not too early to begin making plans for the intended direction for how important infrastructure investments will be funded in the long term.

Strategies for Raising the Revenue Elasticity

The challenge is to design a revenue structure that allows for natural tax revenue growth without rate increases.¹⁵ As already noted, the Kentucky tax structure has been less able to achieve this objective during recent years. Elasticities for each of the major taxes, personal income, corporate income, sales, and property taxes, all slowed during the second half of the 1990s, which means that the tax system is less able to tax Kentucky's growing economy. This suggests that some adjustment could be appropriate for each tax. The total revenue elasticity is a weighted average of the elasticities of the different tax sources, so adjusting the individual tax sources will solve the overall problem.

The best way to evaluate a tax structure is relative to the economy on which it is imposed. In this light, there is no intent in this section to propose any increase in government. Instead, the discussion is focused on how Kentucky can maintain the size of government and continue doing the things it is currently doing. This section identifies alternatives that could assist in raising the growth path for each tax.

Tax Reduction Measures

A series of tax reduction measures, enacted through statute or resulting from court decisions, has been an important reason for the slow tax revenue growth since 1995. In total, these measures are expected to reduce tax revenues by \$258.3 million in fiscal year 2002, and the revenue cost is growing. Several examples can be given of changes that were enacted through legislative statute. The income tax has been significantly reduced by exemption of private pensions and IRAs and by the increase in the standard deduction. Inheritance tax revenues have been lowered through exemption of Class A beneficiaries (defined as immediate family members other than spouses, who were already exempt). Provider tax exemptions were granted for physicians and prescription drugs. These revenues, which would have been used to match federal dollars, must be replaced with general fund revenues. Other changes were brought about through the court system. A court ruling determined that the NADA average retail price was too high for valuing automobiles for property tax purposes. The base was reduced to the mid-point between average retail and average trade-in. Subsequent legislation reduced the base to the

¹⁵ The emphasis here is on the degree to which the tax structure is able to capture additional revenue as economic activity grows. But, broader tax bases and lower tax rates could also stimulate some additional increase in Kentucky economic activity, depending on what tax rates were lowered.

average trade-in price. Also, the intangible property tax was formerly levied on ownership of out-of-state but not in-state stocks. The courts ruled that in-state and out-of-state stocks must be treated the same for intangible property tax purposes, and the legislature fixed the problem by exempting ownership of stock from the tax.

The combination of these tax reduction measures was responsible for more than 20 percent of the extent to which Kentucky's revenue elasticity fell below 1 between 1995 and 2001. Thus, the overall revenue elasticity will be increased significantly by restraint in legislating additional tax exemptions and in redefining the tax base. Future changes in the tax structure should be made in the context of the overall effect on performance of the revenue system.

Personal Income Tax

Personal income tax revenues grew more rapidly than the economy during both the 1988 through 1995-time period and during the second half of the 90s (see Table 2). The elasticity declined during the latter time period, but the apparent slowdown may be partly because of the inability to adjust the revenue data for base changes that were enacted in 1990 (for example, elimination of the deduction for federal income taxes paid). Inability to make the appropriate adjustments could lead to an overstatement of growth in the earlier time.

The most important determinants of income tax revenue growth (the elasticity) are the rate and the exemption/deduction structures. Revenue growth could be enhanced either by making the tax rates more progressive or by raising exemption levels.¹⁶ Kentucky's personal income tax has a progressive rate structure, but the highest rate of 6 percent is imposed on incomes above \$8,000. This means that most families are subject to the highest rate and the rate structure appears nearly proportional for many taxpayers. Exemptions from Kentucky's income tax structure are also relatively small.

A more progressive tax rate structure would raise the elasticity more than increasing the exemption levels. But neither changes in the rates nor in the exemption structure should be made solely to enhance revenue growth. Adjustments of this magnitude should be undertaken only to achieve a broad set of policy objectives. For example, larger exemptions would enhance the system's progressivity (should this be a desirable objective)¹⁷ and increase simplicity by reducing the number of taxpayers, in addition to raising the revenue growth rate. But, the most significant immediate effect of larger exemptions would be a reduction in revenues.

Keeping the base broad by not legislating new exclusions is also important to maintaining the revenue growth. New exclusions, such as those granted for pension

¹⁶ Larger exemptions would reduce the current amount of revenues, but would raise the personal income tax growth rate. Some mechanism would be necessary to replace the lost revenue from the larger exemption.

¹⁷ The income tax's degree of progressivity is not just a function of the tax rates, but also depends on the exemptions, low-income credits, and other characteristics of the tax structure.

income, should be avoided, and where possible excluded income could be brought back into the base.

TABLE 2
Selected Kentucky
Revenue Elasticities

<i>Personal Income Tax</i>	
1988 – 1995	1.73
1995 – 2000	1.13
1988 – 2000	1.48
<i>Sales Tax</i>	
1988 – 1995	0.98
1995 – 2000	0.91
1988 – 2000	0.95
<i>Corporate Income Tax</i>	
1988 – 1995	0.72
1995 – 2000	-0.36
1988 – 2000	0.26
<i>Total Property Tax</i>	
1988 – 1995	0.97
1995 – 2000	-0.07
1988 – 2000	0.53
<i>Real and Tangible Personal Property</i>	
1988 – 1995	1.00
1995 – 2000	0.66
1988 – 2000	0.81
Source: Author's calculations.	

Sales Tax

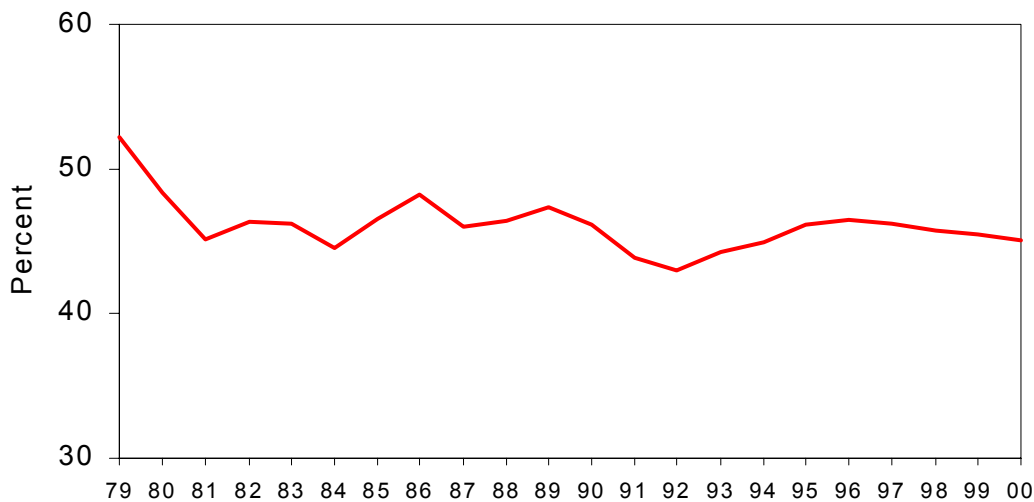
The sales tax elasticity declined from 0.98 during 1988 to 1995 to 0.91 during 1995 to 2000 (see Table 2). The sales tax elasticity is below 1 and is declining for three reasons:

- Legislated exemptions. The Kentucky General Assembly, like those in most other states, enacts new exemptions on a continuing basis. Justifications for the exemptions have varying degrees of validity, but the overall effect is to reduce tax revenues and the revenue growth rate.
- Changes in consumption patterns. The Kentucky sales tax, like that in most states, taxes relatively few services. Failure to tax services reduces the potential revenue growth since individuals are shifting their consumption patterns away from goods and towards services. Goods comprised 52.6 percent of consumption in 1979, but only 41.8 percent in 2000. Services are the remainder, meaning services have grown from 47.4 percent to 58.2 percent of consumption. The changing consumption pattern means a decline in the sales tax base relative to personal income, since few services but most goods other than food are taxed.
- Remote commerce. Mail order and e-commerce are very rapidly growing means of ordering and distributing goods and services. The same tax liability (through either the sales or the use tax) is normally incurred regardless of the means used to order and distribute, but the method for collecting the tax for remote commerce often shifts from reliance on the vendor (sales tax) to reliance on the individual taxpayer (use tax). Compliance with the use tax is much lower than with the sales tax, meaning a significant revenue loss associated

with the transfer to remote transactions. Bruce and Fox (2001)¹⁸ recently estimated that Kentucky lost \$84.0 million in 2001 sales tax revenues from sales that were formerly made within Kentucky and are now made via e-commerce. They estimate that the annual loss could grow to \$286.2 million by 2006. About 70 percent of the loss is associated with business-to-business transactions and the remainder comes from lost taxes on consumer purchases.

These three factors have resulted in the Kentucky sales tax base (including the motor vehicle usage tax) as a share of personal income falling from 52.3 percent in 1979 to 45.0 percent in 2000 (see Figure 10)¹⁹. The largest relative declines in the base occur during recession years like 1980-82 and 1991, so the base can be expected to decline significantly during 2001 and 2002. The sales tax elasticity can be increased (or more likely, the relative sales tax base can be maintained) by changing practices to offset each of the three areas that have resulted in low tax base growth. The suggestions given below can allow the sales tax elasticity to be maintained, but the elasticity will remain lower than 1, meaning sales tax revenues will not grow as fast as the economy. Options include to:

FIGURE 10
Kentucky Sales Tax Base as a Percent of Personal Income



¹⁸ Donald Bruce and William F. Fox, "State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates," *State Tax Notes*, October 15, 2001, pp. 203-214.

¹⁹ Kentucky's sales tax base is a slightly larger share of personal income than the 42.1 percent in the average state.

1. Limit new legislated sales tax exemptions to those that are the most essential based on a broad set of policy goals. This will prevent the tax base from being narrowed and revenue growth from being slowed.
2. Encourage the Kentucky Congressional delegation to support a new nexus standard for remote vendors. Currently, the nexus standard (which determines which vendors must collect the use tax on behalf of Kentucky) is based on a U.S. Supreme Court ruling (*Quill v. North Dakota*, 112 U.S. 298 (1992)) that says that only vendors with substantial physical presence must collect the tax on behalf of Kentucky. This practice places Kentucky vendors at a significant disadvantage since they must collect the sales tax while they compete with remote (often large) vendors that are not required to collect the tax. Also, Kentucky vendors that must comply with the tax bear the compliance costs not borne by the remote vendors. As a result, local vendors face the prospect of losing customers who must pay a higher price because of the tax. The result can be lost jobs in Kentucky, a more regressive sales tax (because of the digital divide, which means low income households have less access than high income households to the internet), and lost revenues for Kentucky state government.
3. While waiting on Congressional action, Kentucky could go farther to require e-commerce businesses to collect the tax. Legislation could be passed to impose a sales tax collection responsibility on dot-com companies that are part of the same corporate structure and have a similar name and that undertake similar business as companies that have nexus in Kentucky. Arkansas passed such legislation and it became effective January 1, 2002. The California legislature passed similar legislation, but the legislation was vetoed by the Governor.
4. The Revenue Cabinet could investigate alternatives for enhancing use tax auditing and compliance. However, the collection of use tax will almost always be more inefficient than collection of sales tax through vendors.
5. The sales tax could be extended to selected services. Unfortunately, the issue is not whether the sales tax should be imposed on services, but instead the question is which services should be subject to the sales tax. Several factors should be considered in determining whether a service belongs in the base, including:
 - Sales tax should only be imposed on services consumed by individuals, but many services (such as accounting services) are used primarily by businesses.²⁰ Further, production exemptions (such as are given for manufacturing firms that purchase certain inputs) should be provided if taxable services are used in the production of other goods and services. Appropriately set, production exemptions will significantly reduce the potential revenues from taxing services.

²⁰ The sales tax is normally evaluated as a tax on consumption. As such, the tax should only be imposed on household purchases and not on business purchases.

- Taxation of some services may be viewed as inequitable. Taxation of at least some forms of health care (cancer treatment, skin grafts for people caught in a fire, and so forth) are examples.
- Taxation of some services is administratively difficult, particularly because of the difficulties of collecting tax on services provided by out-of-state vendors over the Internet and through other remote means. Kentucky service providers would be at a significant disadvantage if the tax on services used in Kentucky was only collected on their sales and not on the sales of out-of-state service providers. Also, service providers are smaller on average than goods providers, so the costs per vendor for collecting the tax on services are higher.

The end result is that the set of services on which tax can be imposed is much narrower than has often been anticipated, and the potential revenue gains (given the narrow base and production exemptions) are much smaller than anticipated. Several areas could be considered as options for taxation. For example, all recreational services could be included in the tax base and rental cars could be taxed at higher tax rates (though an interstate agreement on sales tax simplification could preclude differential tax rates).

Corporate Income Tax

Business tax structures should have two basic characteristics. First, tax burdens should be kept relatively low to increase the chance that business can be successful in Kentucky and so that the taxes do not inhibit the location or expansion of economic activity in Kentucky. Business tax burdens are not excessive if they are set at the amount necessary to finance the public service benefits that businesses receive from Kentucky government (recognizing that this is a useful way to conceptualize the burden, but a difficult concept to implement in practice). Second, tax burdens should be neutral (even) across different industries and different sizes of business. This means that all businesses should pay the same relative tax. The issues discussed below are intended to increase the neutrality of the tax structure and to improve the revenue growth path.

The corporate income tax elasticity has deteriorated more than has the elasticity for other taxes, having fallen from 0.72 to -0.36 (see Table 2). The negative elasticity means that corporate tax revenues have declined since 1995. Growing emphasis on corporate tax planning and the advent of Limited Liability Companies (LLCs) are surely the most important reasons. As with the other taxes, keeping the base broad is essential to maintaining revenue growth. Three steps would help increase corporate tax revenues and revenue growth:

1. Each state decides how related companies are to be combined in determination of their income tax liabilities. Kentucky *allows* voluntary consolidated reporting. Voluntary consolidated reporting expands the tax avoidance options available for businesses, and reduces Kentucky's ability to collect corporate taxes (though the problem is lessened by requiring companies to maintain their election for eight years).

Related companies can be expected to combine their activities for tax purposes when the combination will reduce their tax burden and to file separate returns when it does not. About 15 states require combined reporting, which means that related companies *must* file a consolidated return. This prevents companies from structuring their operations into multiple corporations in order to lower their tax burden.²¹ Kentucky could move to required combined reporting, or at a minimum could eliminate voluntary consolidated reporting.

2. LLCs were first permitted in Kentucky in 1994. By 1999, there were 5,942 LLCs, representing 5.3 percent of businesses in Kentucky. Like most states, Kentucky did not simultaneously revise its tax statutes when it legislated the LLC as a possible organizational structure. The tax structure currently allows three ways that selection of the LLC form lessens tax liabilities:

- LLCs are not required to pay corporate license taxes.
- The income of multi-state LLCs is apportioned using a single factor sales formula (following the tax treatment of partnerships). The single factor formula allows a Kentucky manufacturing firm to form an LLC with all of its activities in Kentucky except for a sales office that it locates in a state that does not use a single factor sales formula. The situsing of sales for tax purposes in the other state will significantly reduce the Kentucky tax liability, but will not concomitantly increase the tax liability in another state that uses a lesser weighting on the sales factor.
- Profits earned by LLCs may be passed to their members, and taxed at that level. Thus, a multi-state company may choose to organize its Kentucky operations within an LLC and to own the LLC through a Delaware corporation that has no presence in Kentucky except via ownership of the LLC. There is question whether the Delaware corporation has nexus in Kentucky, and even if it does, whether the corporation will properly file tax returns in Kentucky.²²

LLCs could be brought under the same tax statutes as other corporations doing business in Kentucky. This means that LLCs could 1) pay the corporate license tax and 2) have multi-state income apportioned in the same manner as other corporations. In addition, a withholding tax could be imposed on all LLC income passed to non-resident members (about 10 states have such legislation) to ensure collection of the tax due on LLCs' Kentucky activity.

3. Ten enterprise zones have been created as a result of legislation that was first passed by the Kentucky General Assembly in 1982 and was subsequently expanded. The

²¹ See Michael J. McIntyre, Paull Mines, and Richard D. Pomp. "Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana." 2001.

²² See Elisa Fay and Sharlene Amitay, "Attention LLC Members: Is Nexus a Foregone Conclusion?" *State Tax Notes*, September 10, 2001, pp. 821-826.

geographic applicability of enterprise zones has been significantly extended over the years. Recent estimates suggest that the tax concessions provided by enterprise zones cost \$45.75 million in calendar 1999. Most of the cost is lost sales taxes for building materials and the purchase of equipment and machinery.²³ Further, a number of analysts across the country have questioned the economic benefits of tax concessions within enterprise zones. The enterprise zone legislation could be allowed to expire. Expiration of the legislation would slowly increase tax collections over a number of years.

4. Kentucky statutes state that “every foreign corporation owning or leasing property located in this state or having one or more individuals receiving compensation...” (KRS 141.040) has nexus for corporate income and license tax purposes. This physical presence approach to determining taxable status is very restrictive relative to other states, all of which determine nexus based on the standard of doing business and/or deriving income in the respective state. The physical presence nexus standard used by Kentucky has several problems including: 1) Kentucky collects less tax revenue than otherwise would be due, 2) corporations investing and/or having employees in the Commonwealth pay taxes while other corporations benefiting from the state economy do not, and 3) Kentucky is less able to tax the rapidly growing service sector than are other states.

The Revenue Cabinet has recognized the problem with the nexus standard and has identified a number of businesses that would be taxable under a broader nexus standard. Among the types of businesses identified by the Revenue Cabinet that would be taxable under a standard based on doing business in the Commonwealth, but which are not taxable under the existing standard are foreign corporations that:

- Regularly render a service to clients in Kentucky using representatives or employees.
- Sell goods through mobile stores, such as trucks with drivers acting as sales persons.
- Conduct seminars in the Commonwealth.
- Operate professional sports teams that engage in professional activities in the state.
- Perform contractual agreements, prime or sublet work, for the construction, repair or renovation of real or personal property

The nexus standard used to determine liability for the Kentucky corporation income and license taxes could be redefined to include any corporation that is organized under the state’s laws, has commercial domicile in the state, owns or leases property in the state, has at least one person performing services in the state, derives income from sources within the state, or directs activities at Kentucky customers for purposes of selling them goods or services. The revenue consequences of this broader nexus standard are estimated to be no more than \$1 million annually during the next several years, but

²³ See “The Cost of Kentucky’s Enterprise Zones,” Policy Paper Series 2, Issue 1, Office of the State Budget Director, Governor’s Office for Policy Research, Commonwealth of Kentucky, January 2002.

the Revenue Cabinet believes that the revenue could grow as the standard becomes better known and as firms that owe the tax are identified.

Property Tax

Kentucky state government taxes intangible, real and tangible personal property. The elasticity has fallen from 0.97 during the earlier time period to -.07 in the more recent years (see Table 2). Much of the explanation for the decline in revenue in recent years lies in the 1997 policy decision to exempt stock from the intangible property tax. Still, the elasticity of tax on real and tangible personal property has fallen from 1.0 to 0.66.

H.B. 44 limits real property tax revenue to four percent annual growth for both state and local governments. The limit makes it very difficult for the property tax to have an elasticity of 1.0 since revenue growth of four percent lies well below the annual personal income growth rate of between five and six percent (of course, the elasticity could be 1 if tangible property was growing sufficiently fast). The methodology used to calculate the limit differs for the state and the local governments. The limit on local governments effectively prevents the tax on *existing* property from rising by more than four percent each year, but does not prevent total real property from rising over four percent. This is achieved by subtracting out new property from the base against which the limitation is applied and thereby only applying the limit to existing property. New property is not excluded in calculation of the state limit, meaning the limitation is much more binding for the state (the elasticity is lower). The property tax elasticity would be increased significantly by calculating the state limit in the same manner as the local limit (but the elasticity would probably still be below 1.0).

The property tax rate has been reduced from 31.5 cents per hundred dollars to 13.4 cents per hundred dollars as a result of HB44. Freezing the tax rate at its current level would be a more effective means of increasing the property tax elasticity than redefining the way in which HB44 is imposed (as discussed in the previous paragraph). Revenues would grow at the rate that the total of all property values increases, including the effects from increases in new and existing property, if the rate was held constant. The property tax elasticity would be close to 1.0 if this change were made.

III. THE TAX SYSTEM AND FAMILIES

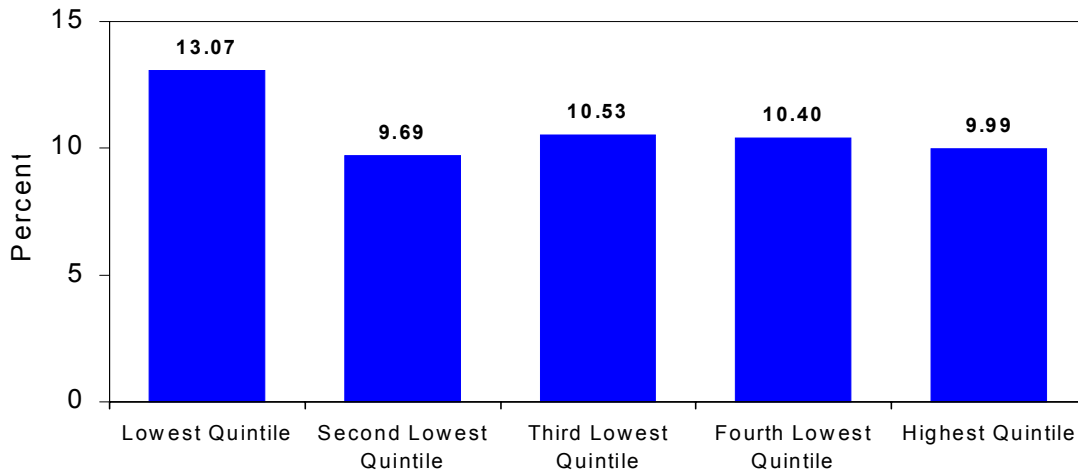
Concerns have been raised about the tax burden on families and low-income taxpayers. Two concepts, vertical equity and horizontal equity, are frequently used when assessing the fairness of taxes. Vertical equity is a consideration of the tax burden of people with different incomes (different capacities to pay taxes) and horizontal equity is an assessment of the tax burden of people with similar incomes (the same capacity to pay taxes). This section provides consideration of several issues related to vertical and horizontal equity.

Vertical Equity

For vertical equity, it is important to evaluate equity in terms of the entire tax structure, and not in terms of any single tax, since taxpayers may have high burdens on one tax, and low burdens on another. Several studies of the Kentucky tax system's vertical equity have recently been completed. The Barents' Group (1999) determined that the overall tax system was approximately proportional, meaning that people with different incomes paid approximately the same percentage of income in taxes. LRC staff (see Figure 11) found the system is approximately proportional, except for the lowest income taxpayers, where the tax is regressive (meaning low-income taxpayers pay a higher percentage of income in taxes than higher income taxpayers). By tax, the burden is progressive for the state income and local occupational taxes and is regressive for the sales, excise, property, and motor vehicle property taxes. The study found that most states have a regressive tax structure at the low end, and that the degree of regressivity is lower in Kentucky than for the average state. The finding is that the burden on low-income taxpayers is 11th from the bottom, but the burden on high-income taxpayers is 40th from the bottom. So, the perception apparently held by some, that the Kentucky state/local burden on low-income individuals is high, is at least not true by comparison with the situation in most other states.

Whether a regressive tax burden is unfair is a value judgment about which people may not agree. First, by definition a regressive tax means lower-income citizens pay a higher percentage of income in taxes than higher-income groups. But, higher-income people generally pay more tax dollars. Whether this is unfair depends on the standard being applied for deciding how *much more* taxes people should pay as their income rises. Second, low-income residents often receive more public services, so the overall government system may not be regressive, even if the taxes are. Third, the federal income tax is progressive, so the combined government tax structure is not as regressive as the state-local burden.

FIGURE 11
Share of Income Paid in Taxes



Several means are available to change the structure if a decision is made to decrease the percentage of taxes paid by the lowest income Kentuckians. Of course, decreasing the low-income tax burden means less tax revenues, and the revenues must be replaced with a tax on individuals with incomes above the lower levels, or the size of government must be reduced. Higher-income Kentucky taxpayers already pay a relatively large share of income in taxes relative to other states and low-income taxpayers pay a relatively small share by comparison with other states, and a shift in the relative tax burden will exacerbate this situation.

- Elimination of the property tax on motor vehicles would be a significant step in reducing the tax burden for low-income citizens. LRC estimated that the property tax on motor vehicles is 1.51 percent of income for low-income taxpayers, but only 0.39 percent for the highest income taxpayers (see Table 3). Replacement of this tax with one paid relatively more by high-income people would make the structure must less regressive.
- The state income and local occupational taxes each represent only 4 percent of the low-income tax burden (less than 0.5 percent of income) so the reduction in tax burden that these taxpayers would experience from larger exemptions for the state income tax is relatively small (see Table 3). A refundable tax credit would provide lower-income individuals more benefits since it combines transfer payments to individuals with the tax system.

TABLE 3
Kentucky Tax Burdens, Families by Quintile

Tax	Lowest Income Quintile		Highest Income Quintile	
	Tax as a Percent of Family Income	Tax as a Percent of Total Tax	Tax as a Percent of Family Income	Tax as a Percent of Total Tax
State Income	0.49%	4%	5.24%	52%
Local Occupational	0.47%	4%	0.94%	9%
Sales	5.50%	42%	1.63%	16%
Excise	1.78%	14%	0.19%	2%
Property	3.32%	25%	1.60%	16%
Motor Vehicle	1.51%	12%	0.39%	4%
Total	13.07%	100%	9.99%	100%
Source: Legislative Research Commission.				

- The LRC staff study found that 42 percent of the low-income tax burden arises from the sales tax (see Table 3). The sales tax is an obvious option for reducing low income taxes because it raises such a large share of the overall burden. A common idea is to exclude certain items from the base, as is done for food consumed at home, in an effort to reduce taxes paid by low-income individuals. But, it is very difficult to target the benefits to low-income people since the tax is collected from vendors not individuals, meaning the items will also be excluded from the tax base when sold to higher income people. In any event, it is nearly impossible to select a set of items that would be progressive in taxation because low-income citizens spend a greater percentage of their income on nearly every broad category of goods and services. Also, enacting new exemptions often imposes significant administrative and compliance costs on the Revenue Cabinet and the vendors responsible for collecting the tax. A better means is to reduce the sales tax rate and replace the revenue with higher income tax rates. The tax burden for low-income citizens can be reduced by 0.92 percent of their income for each 1.0 percent reduction in the rate (depending on how the revenue is replaced). Taxes for the highest quintile of taxpayers would be reduced by only 0.27 percent for each one-percent sales tax reduction. Thus, high-income people would reap less benefit from a lower sales tax rate and would pay more of any income tax increase.
- The property tax is 25 percent of low-income citizen's tax burden (see Table 3). Reduction in the rate, or enactment of low-income credits or exemption could reduce tax burdens significantly.

Motor Vehicle Property Tax

Kentucky voters passed a constitutional amendment in 1998 to allow the property tax on automobiles to be eliminated. General Assembly action is required to abolish the tax, which is levied at 45 cents per \$100 of fair value plus a local tax rate. Property taxation of motor vehicles raises about \$75 million at the state level and about \$160 million at the local level, but its elimination can be justified in several ways:

- Many voters are believed to have voted for the constitutional amendment thinking that the tax would be eliminated. Thus, abolishment of the tax would be a politically popular change.
- Kentucky is one of a diminishing group of states that is retaining taxes on tangible personal property owned by people. The unpopularity of the taxes and the administrative inability to include the broad range of tangible personal property held by individuals (thereby resulting in horizontal inequities) are among the reasons that other states have removed tangible personal property from their base.
- Elimination of the tax would be an effective means of reducing the low-income tax burden.

The major concern is how to replace the lost revenue. The revenue consequences can be limited by only eliminating the state portion of the tax. Each local government could be allowed to retain or independently abolish its motor vehicle tax. Remaining resources in the Underground Storage Tank Fund are one option for replacing the lost state revenues. Some other options discussed in this paper would raise money that could be used to finance elimination of the property tax on motor vehicles.

Horizontal Equity

Normally, taxes are regarded as horizontally equitable when people with the same income pay the same taxes. The best way to achieve this objective is to legislate very broad tax bases so that people with the same income pay the same taxes, regardless of the form in which they receive their income. Similarly, people with the same consumption pay the same sales tax, and so forth.

Deduction for Foreign Income Tax

A set of tax reforms was enacted in 1990, including elimination of the deduction for federal income taxes in calculation of Kentucky state personal income taxes. The deduction for income taxes paid to foreign governments was not eliminated at the same time, thereby creating a horizontal inequity. Two taxpayers with the same income will have different state tax burdens if one earns income and pays income taxes in a foreign country and the other earns income and pays income tax to the U.S. Deductibility of national taxes should be treated similarly, regardless of which government receives the

revenue, and a deduction for foreign but not U.S. income tax is particularly difficult to justify. Consideration should be given to eliminating the deduction for income taxes paid to foreign countries.

Most other states provide no deduction for national income taxes. One reason is that it makes the state income tax less progressive, since payment of the progressive federal tax will provide a greater deduction for higher income taxpayers. Also, the deduction reduces state tax revenues.

Taxes on Tobacco Products and Other Excise Taxes

Kentucky imposes an excise tax on cigarettes, but not on other tobacco products. The result is horizontal inequities between users of similar tobacco products. A tax on smokeless tobacco, cigars, rolling paper and other related products could be levied to allow other tobacco products to be taxed in a comparable manner to cigarettes. Such a tax can help finance other essential reforms.

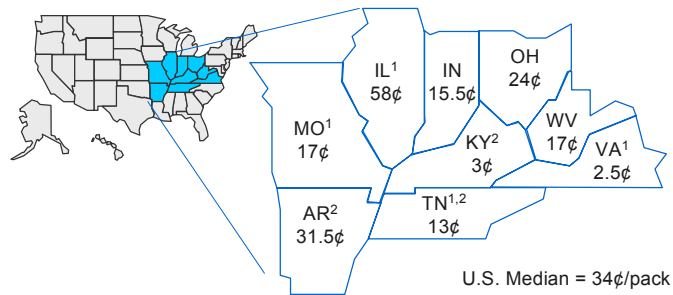
Kentucky excise tax rates on tobacco, beer, and alcohol are very low on national standards. Cigarette tax rates, at 3 cents per pack, are next to the lowest in the country, and are 31 cents per pack below the U.S. median (see Figure 12). Kentucky's rate is at least 10 cents lower than all neighboring states except Virginia. More than 20 states are reported to be considering increases in cigarette tax rates this year. There are two reasons to consider raising the tax rate in Kentucky. First, health benefits would result for smokers and non-smokers to the extent that higher tax rates discourage smoking. Second, higher rates could help offset proposals that would lower tax revenues, and could help finance the revenue shortfall that is currently occurring.

Similarly, alcohol and beer tax rates are very low on the standards of other states.²⁴ For example, beer excise tax rates are less than one-half of the U.S. median rate and are lower than all neighboring states except Missouri (see Figure 13). Consideration could be given to raising tax rates on distilled spirits, wine, and beer.

Two concerns about higher excise tax rates should be noted. Kentuckians will not have an incentive to shop in other states if rates are increased, but are generally kept in line with neighboring states. Still, non-residents will have less incentive to shop in Kentucky. Also, taxes on cigarettes, beer and alcohol are generally inelastic, since the taxes are levied on the quantity rather than the value of sales.

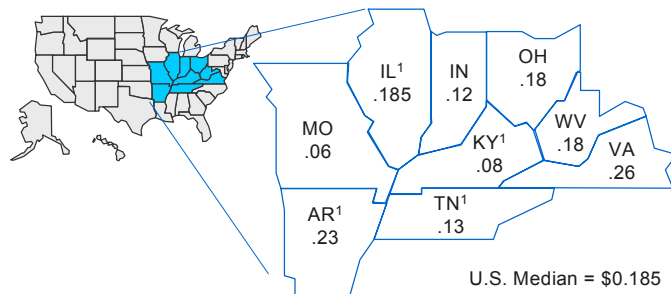
²⁴ An additional 9 percent wholesale tax rate is imposed in Kentucky on beer, wine, and distilled spirits, but the tax is levied in lieu of the general sales tax.

FIGURE 12
State Excise Tax Rates on Cigarettes, Cents Per Pack, January 2002



¹ Counties and cities may impose an additional tax on a pack of cigarettes: IL 10¢-15¢; MO 4¢-7¢; TN 1 ¢; VA 2¢-15¢.
² Dealers pay an additional enforcement and administrative fee: KY 0.1¢; TN 0.05; AR \$1.25/1,000 cigarettes.

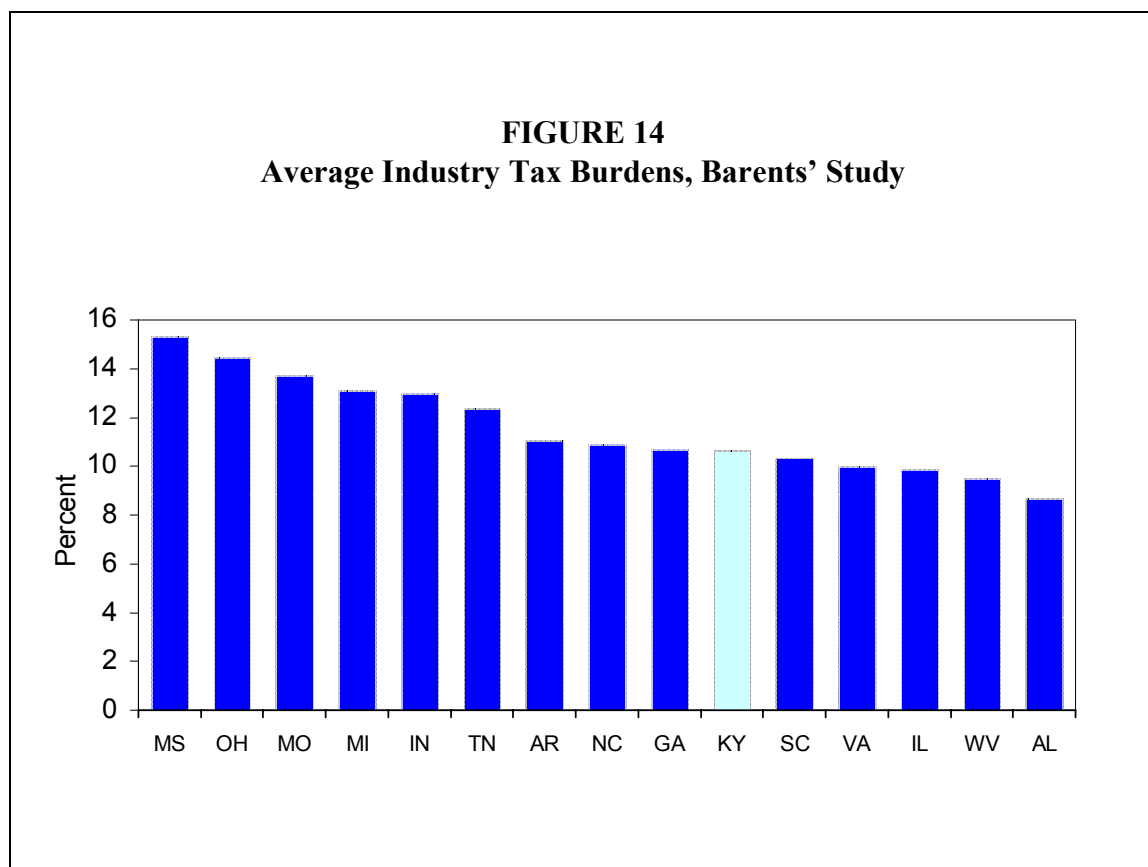
FIGURE 13
State Excise Tax Rates on Beer, Dollars Per Gallon, January 2002



¹ Additional taxes:
 AR—under 3.2%—\$0.16/gallon; \$0.0008/gallon and 3% off-premise and 10% on-premise.
 IL—\$0.16/gallon in Chicago and \$0.06/gallon in Cook County.
 KY—9% wholesale tax.
 TN—17% wholesale tax.

IV. THE TAX SYSTEM AND BUSINESS COMPETITIVENESS

Businesses are subject to essentially every tax, whether imposed only on the business form, such as the corporate income tax, or imposed on people and businesses, such as property and sales taxes. Kentucky imposes relatively high income tax rates on corporations, but raises relatively little revenue compared to most other states, evidencing that the tax base has been narrowed in a number of ways. The consequence is effective tax rates are lower than the legislated tax rate would suggest. The Barents' Group (1999)²⁵ used data on a number of taxes to conduct the latest broad study on tax competitiveness and concluded that the average tax burden, when all factors are considered, is not out of line with other states. Kentucky was found to rank 10th among 15 neighboring and southeastern states (see Figure 14). Thus, the overall tax burden does not create competitive problems for Kentucky.



The average tax burden is not useful for examining how individual businesses and industries are affected by the tax structure. Instead, a more specific analysis must be undertaken. Barents' concluded that the business services, computer services, and health services industries face relatively high tax burdens compared with other states. On the other hand, the agriculture, printing, industrial chemicals, and primary metals industries

²⁵ Barents Group, "Comparative Analysis of Kentucky's Tax Structure," Report submitted to the Office of Financial Management and Economic Analysis, Commonwealth of Kentucky, December 1999.

face relatively low burdens on the standards of other states. Thus, the tax structure is not neutral, meaning the tax burden is not even across industries, nor does it levy even burdens relative to other states. The presence of tax concessions, credits and so forth result in a tax burden that varies between industries, as well as between firms within individual industries. The sales and property taxes can also have widely different effects depending on specific characteristics of the firms. A general observation from the Barents' study is that Kentucky taxes are higher on emerging and growth industries than on traditional industries. This could inhibit economic growth to a limited extent.²⁶

The competitive environment would be improved through the greater neutrality achieved by required combined reporting, even tax treatment of LLCs, and expiration of the enterprise zones, as described above in the section on enhancing the revenue elasticity. These suggestions would be good tax policy even if the corporate tax rate were reduced to offset any additional revenue that would be raised at the current time. Kentucky imposes a maximum 8.25 percent corporate income tax rate, the 15th highest rate in the U.S., and the rate could potentially be lowered.

Several other business tax issues are addressed in this section, including taxes on merchant power, interstate trucking, and telecommunications.

Merchant Power Plants

Proposals have been made to locate approximately 20 merchant power plants in Kentucky (there is currently one merchant power plant in Kentucky). Merchant power plants are electric generation facilities that sell their output on the wholesale market. Kentucky appears to be a prime location for such facilities because of the way that major natural gas pipelines and the electric transmission grid run through the Commonwealth. In addition, access to Kentucky coal could be advantageous for firms that are locating a coal-fired facility. Despite the advantages that Kentucky offers to the proposed plants, the Public Service Commission believes that only about one-third of the proposed merchant power capacity is actually likely to locate and operate.

Merchant power companies appear to offer few benefits to Kentucky. The power is being produced for wholesale and is not currently necessary for use in Kentucky. The plants employ relatively few people and may use little other resources. Further, the production of electricity may create significant pollution and can increase the likelihood that communities where the plants locate violate attainment standards, thereby precluding the development of economic activities that could be more productive for Kentucky's economy. The plants also offer limited potential tax revenues. As the tax statutes are currently structured, these firms would be subject to the public service company property

²⁶ A voluminous literature exists on the effects that taxes have on the location of business and jobs. The general conclusion is that taxes can have an effect on location, but the effects are small and have relatively little implication for public policy if the tax structure is kept broadly competitive with neighboring states. See Michael Wasylenko "Taxation and Economic Development: The State of the Economic Literature," *New England Economic Review*, March/April 1997, pp. 37-52. for a recent summary.

tax, and as such would not be subject to the corporate license tax. Further, many of these plants are organized as LLCs, and offer the potential tax issues raised above.

Consideration could be given to imposing a new tax on generation of merchant power in order to enhance the benefits from the merchant power firms and to charge for the costs that these firms would impose on Kentucky, including additional pollution and elimination of other economic options. One possible mechanism would be to levy a tax (perhaps equal to \$.001 per kilowatt-hour) on the production of merchant power in Kentucky (defined as power produced at wholesale and sold at rates that are not regulated by Kentucky). Such a tax must be levied on all merchant power and not just power for consumption outside the Commonwealth because of the Constitutional prohibition on interfering with interstate commerce. The existing \$2 per ton credit granted for Kentucky coal used in electric generation could be allowed against the electric production tax, thereby giving the coal-fired plants an incentive to burn Kentucky coal. The \$2 credit is nearly sufficient to offset a \$.001 power generation tax for a coal-fired plant exclusively burning Kentucky coal. Thus, firms that produced electricity with Kentucky coal would have almost no additional tax burden but all other firms would bear a tax. The tax with a \$.001 rate and a \$2 credit would raise about \$8 million for the general fund.

Several factors should be considered in making a decision on the new tax. Some of the merchant power is likely to be sold back into Kentucky and Kentucky ratepayers would bear some of the tax. Nearly one in six Kentuckians could face a higher price for electricity, but the effects would be very small since relatively little of the power would be sold back into the Commonwealth. Also, only three states impose a tax on electric generation, and no state imposes the tax only on merchant power plants. Thus, the tax could discourage location of merchant power in the state, but Kentucky faces relatively little risk because the economic benefits are so small. Finally, the credit encourages the firms to burn Kentucky coal, thereby spreading out the benefits, but coal-fired plants are likely to cause greater pollution than gas plants and they increase the chance that places violate the attainment standards.

Taxes on Interstate Trucking

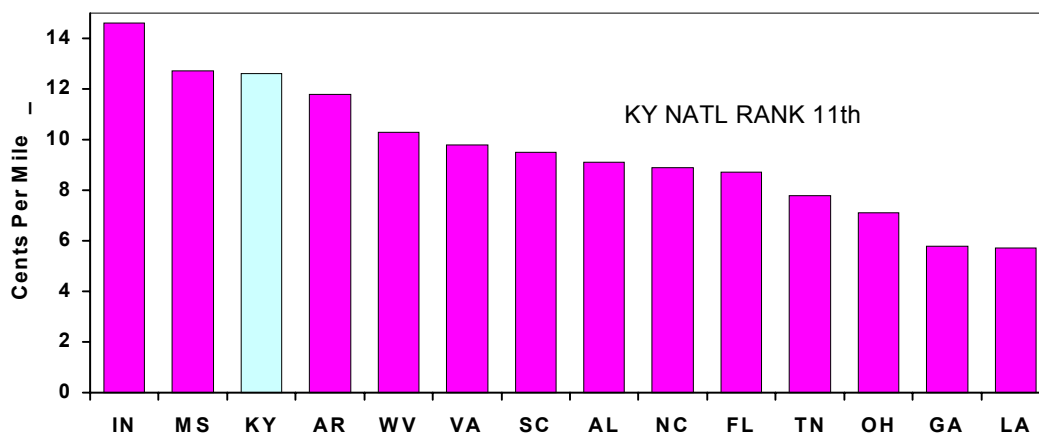
Kentucky, like most states, imposes higher taxes per mile on large trucks than on smaller trucks. An example of the difference is given by the information in Figures 15 and 16, which show that 80,000 pound trucks (most of which will operate in an interstate environment) pay 12.6 cents taxes per mile and 30,000 pound trucks (any of which will operate in Kentucky) pay 3.2 cents per mile. Two issues regarding the taxation of interstate trucking are raised here: whether the motor vehicle usage tax on large trucks and the weight-distance tax should be retained. Changes in each of these taxes have implications for the Road Fund, not the General Fund.

Motor Vehicle Usage Tax on Large Trucks

The Motor Vehicle Usage Tax is a 6 percent levy on the purchase of vehicles, including the purchase of trucks used in interstate commerce. A major concern with

imposing the tax on large trucks is it creates a significant disincentive for trucking firms to locate in the Commonwealth. Most other taxes that are imposed on large trucking firms are apportioned across states according to where the trucks operate, so the tax burden is basically independent of the headquarters location of the trucking company. But the Motor Vehicle Usage Tax is not apportioned, so it is a tax imposed on the decision to locate and register trucks in Kentucky. There is evidence that the Kentucky trucking industry is smaller than should be expected, and the Motor Vehicle Usage Tax may be one reason. It is very uncommon for states to impose their sales tax (which is a counterpart to Kentucky's tax) on large vehicles used for interstate trucking. Tennessee, for example, provides a specific exemption for large trucks used in interstate commerce.

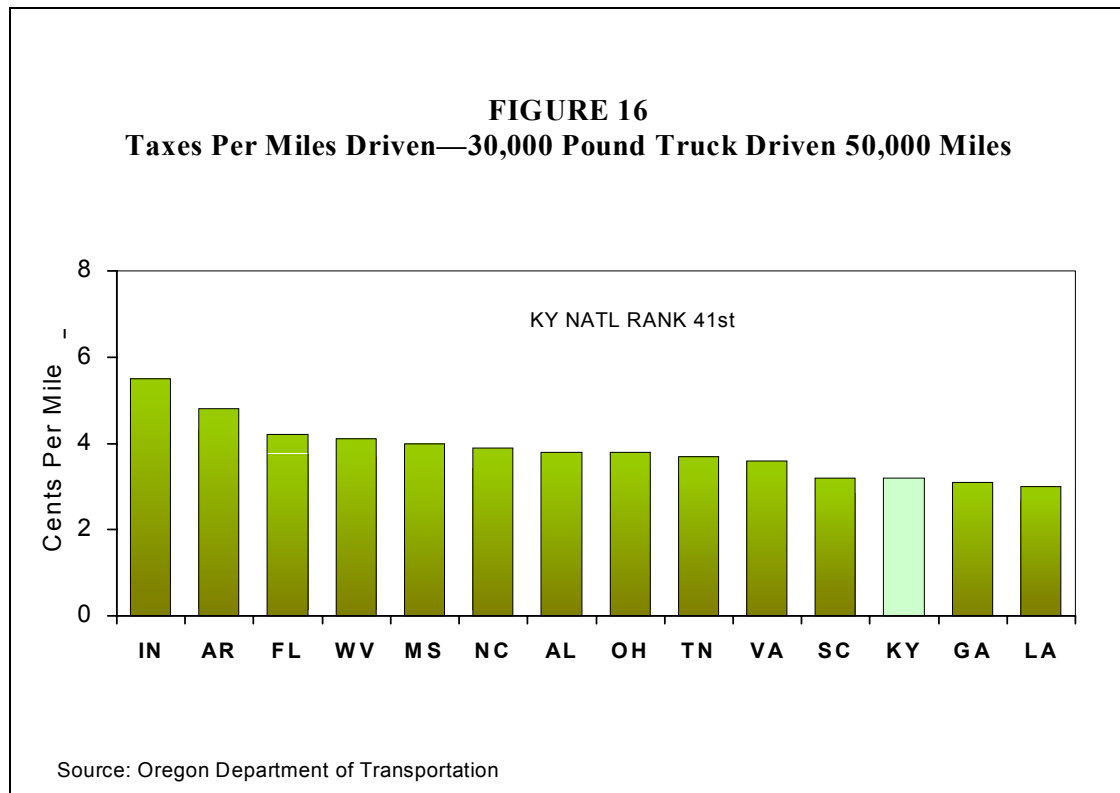
FIGURE 15
Taxes Per Mile Driven-- 80,000 Pound Truck Driven 50,000 Miles



Source: Oregon Department of Transportation

Consideration should be given to eliminating the Motor Vehicle Usage Tax on large trucks in order to enhance Kentucky's attractiveness as a headquarters state for trucking. Exemption would reduce tax revenues by about \$9.3 million annually (about \$6 million from interstate trucking and about \$3.5 million from intrastate trucking). The exemption could be limited to trucks in interstate commerce, but this is difficult to administer. Taxpayers could claim that trucks only intended for use inside Kentucky are being purchased for interstate purchases, and this is difficult to monitor. Tennessee recognizes that it loses tax revenues from improper claims about where vehicles are to be used, but has concluded that it cannot fully prevent fraudulent claims. Also, individuals purchasing smaller trucks could obtain a license for a larger truck and claim exemption from sales taxes on their purchase. The truck registration could be changed to one for a

smaller truck in the years after the purchase. Significant administrative costs could be incurred in reducing the revenue losses from these evasion schemes.



Weight-Distance Tax

Kentucky is one of only four states that continues to impose a weight-distance tax on the operation of large trucks in Kentucky. The weight-distance tax is an important reason, though not the only reason, why heavier trucks pay more taxes per mile traveled in Kentucky. Most states have moved from weight-distance taxes to registration fees and higher taxes on motor vehicle fuels. The registration fees and motor fuel taxes can be operated through the IRP program. Nonetheless, weight-distance taxes offer the major advantage of imposing taxes in relationship to the distance that trucks travel in Kentucky and to the weight of the trucks – two factors that bear a close relationship to the costs that trucking imposes on Kentucky’s highway system. Indeed, research has suggested that the difference in taxes per mile shown in Figures 15 and 16 would not fully account for the difference in costs imposed by the heavier trucks.

There is no compelling reason to move from the existing weight-distance structure to a tax system based on higher registration fees and diesel fuel taxes. Weight-distance taxes are not administered through the IRP, but the information necessary to comply with the tax is already prepared for the IRP and is currently provided to Kentucky. Thus, the tax does not create unreasonable burdens on the trucking industry. The weight-distance tax is apportioned in Kentucky based on usage, so it does not create a disadvantage for headquarters locations in Kentucky; the taxes depend on where trucks

travel and not where they are headquartered. Further, increasing registration fees and diesel fuel taxes will impose higher taxes on Kentucky residents than the weight-distance taxes, as it shifts costs from the heavier trucks to lighter trucks. Higher diesel fuel taxes also have a slight tendency to encourage trucks to purchase fuel outside Kentucky.

Horse Racing Industry

The horse racing industry indicated to the committee that it finds the racing tax structure generally acceptable. Further, the industry believes that the revenue raised through the taxes should be spent to improve the competitiveness and successfulness of the industry, which is generally occurring. Two sets of concerns were raised about treatment of the horse racing industry. One is that tracks with an average handle of greater than \$1.2 million pay a 3.5 percent tax rate, and tracks with a lesser handle pay a 1.5 percent tax rate. There is interest in equalizing the tax treatment at the lower rate. However, the key industry concern is that the Kentucky horse racing industry is competing directly with well-funded and very rapidly growing forms of gambling in Illinois, Indiana, Ohio and other states. Dealing with the industry's competitiveness requires addressing a broad set of Kentucky public policies towards gambling, horse racing and the way that tax revenues raised through the industry and in other ways are used. These issues are much broader than the set covered by this report, and are not addressed here.

High-Tech Policy

The Kentucky General Assembly recently created a high level focus on the High Tech industry. This involved creation of an Office of the New Economy which operates out of the Governor's Office to design high tech policies, including tax policies. A set of proposals on the new economy has been developed and is in the proposal stage. The proposals include some that have modest implications for the personal and corporate income taxes and the local occupational privileges tax. The proposals do not have major implications for state tax revenues, but would reduce revenues to some extent. The ideas are too new and the potential gains too uncertain at this point to provide a detailed assessment of these proposals. Further, the implications are much broader than tax concerns.

Telecommunications Taxes

Both Kentucky state and local governments impose taxes on the telecommunications industries (and its consumers), including the 6 percent state sales tax on many telecommunications services, franchise and school taxes on cable television, and school taxes on inter-county telecommunications. The sales tax base was recently expanded to include long distance services.

Telecommunications tax reform would be sensible to achieve three goals. First, taxation within the industry should be neutral; meaning all competitors within the industry should be taxed in the same manner. Providers of direct broadcast satellite, cable

television, Internet access, long distance telephone, local telephone and so forth provide many services in direct competition with each other, and the similarity of service offerings is growing. These firms should be taxed in a comparable fashion so that none is tax-advantaged relative to the others. Then, consumer decisions on which services to use will be based on the actual costs of delivering the various services and the quality of the services received, rather than tax differences. Many differences in tax treatment exist at the current time. For example, services offered by municipal cable companies are not subject to local taxes while private cable services are. Cable services are not subject to the sales tax while telephone services are. Direct broadcast satellite services are not subject to either local ad valorem taxes or the sales tax.²⁷ All of these services should be brought within a single tax system.

Second, tax cascading should be limited wherever possible. This means the tax should not be levied on the same service (or on substantial inputs) at more than one level in the production process. Elimination of cascading would ensure that the total tax burden is transparent and is the same across all types of firms in the telecommunications industry. One example of cascading is when the access charges paid by long distance companies to local service companies are taxed along with the final telephone service, as occurs today. The cascading probably gets reflected in higher product prices and means the effective tax rate is higher than the legislated rate. The tax on access charges amounts to about \$47 million per year and ultimately should be eliminated.

Third, the tax system should be simplified. The existing structure imposes multiple taxes on the same base, requires firms to determine the municipality where services are provided and creates difficult issues of what is a taxable transaction. The system results in high compliance and administration costs and the potential for frequent litigation.

These three goals can be achieved by imposing an ad valorem (percent of sales) tax on all businesses competing in the very broadly defined telecommunications industry. It is very difficult to enumerate all aspects of the telecommunications industry in legislation because it is changing quickly, so the industry should be defined in very broad, encompassing terms rather than trying to identify specific types of competitors. Most discussions in Kentucky have presumed that the current revenues raised by telecommunications taxes should be maintained, so the ad valorem rate would need to be high enough to replace revenues currently raised by the 6 percent sales tax rate and the local taxes (the local taxes were estimated to be about \$68 million in 2000).

Restructuring the tax base to reflect the three goals would result in access charges being eliminated from the base and cable television and direct broadcast satellite being added to the base. A combined state/local rate on the reformed base that is considerably higher than the 6.0 percent state rate would be necessary to replace all existing revenues. The rate could be reduced somewhat in the near term if taxation of the access charge was phased-out rather than being immediately exempted. But the phase-out period would

²⁷ Federal legislation only permits taxes on direct broadcast satellite services to be imposed at the state level.

need to be long and the future rate would be little changed by this approach. Tax revenues from this base will probably grow only 2 to 3 percent annually, given the most recent estimates of the telecommunications industry's revenue growth. This will allow for modest tax revenue increases in future years.

Designing a mechanism to hold each local government harmless is one challenge. There are two mechanisms that could be used to replace the local revenues that are currently being generated from telecommunications related taxes: a formula basis or a local option tax. With the formula approach, a single state tax would be used to collect revenues for both the state and local governments. A formula would be used to allocate the local share of the revenues (the amount collected above the 6 percent rate) between the local governments that currently impose the tax. This creates the obvious problem that all Kentucky telecommunications consumers would pay the new combined state and local rate, but only local governments currently receiving telecommunications tax revenues from the industry would receive a local distribution.²⁸ Alternatively, local governments could be permitted to levy their own local option tax rate on telecommunications services. The tax could still be collected by the Revenue Cabinet to limit the compliance costs. The combined state and local rate would need to be higher in some places than the average rate described above to replace the lost revenues.²⁹ This option would allow places that do not currently impose a tax on the telecommunications industry to subsequently impose one and would preclude difficult discussions on a formula. Tax on direct broadcast satellite would need to be levied at the state level and the revenue distributed to local governments, regardless of the general approach that is adopted.

Recent federal legislation (the Mobile Telecommunications Sourcing Act) requires states to bring tax structures into compliance with certain guidelines if mobile telecommunications are to be taxed. The Act requires that the tax on wireless telecommunications be imposed by the jurisdiction that encompasses the wireless customer's place of primary use. Kentucky should pass the appropriate implementing legislation as soon as feasible. Failure to enact conforming legislation will prevent Kentucky from imposing a tax on wireless service.

²⁸ A distribution could be made to all local governments, but a higher tax rate would be necessary if local governments currently collecting revenues from these taxes were held fully harmless and revenues were also given to governments collecting no revenues or below-average revenues from the industry.

²⁹ The average state/local rate would replace existing revenues, but would raise revenues in places that do not currently impose any taxes on the telecommunications industry. Thus, tax rates levied only in places currently imposing the taxes must be at higher rates if all of the revenue is to be replaced.

V. POLICY OPTIONS

Consideration should be given to the following options.

1. Changes in the revenue structure, and particularly reductions in tax bases and rates, should only be made if they are part of an overall plan that takes into account the desired revenue elasticity and other goals for the tax system.

Sales Tax Options

2. Encourage the Kentucky Congressional delegation to support a new nexus standard that requires remote vendors with substantial activity in the Commonwealth to collect tax on behalf of Kentucky.
3. Impose a sales tax collection responsibility on dot-com companies that are part of the same corporate structure and have a similar name and that undertake similar business as companies that have nexus in Kentucky.
4. The Revenue Cabinet could investigate alternatives for enhancing use tax compliance through improved tax auditing. However, the collection of use tax will almost always be more inefficient than collection of sales tax through vendors.
5. Extend the sales tax to selected services, including all recreational services and rental cars (which could be taxed at a differentially higher tax rate).

Corporate Tax Options

6. Move to required combined reporting, or at a minimum, eliminate voluntary consolidated reporting.
7. Tax LLCs like corporations by requiring them to 1) pay the corporate license tax and 2) have multi-state income apportioned in the same manner as other corporations. In addition, consider imposing a withholding tax on all LLC income passed to non-resident members (about 10 states have such legislation) to ensure collection of the tax due on LLCs' Kentucky activity.
8. Allow the enterprise zone legislation to expire.
9. Redefine the nexus standard used to determine liability for the Kentucky Corporation Income and License Taxes to include any corporation that is organized under the state's laws, has commercial domicile in the state, owns or leases property in the state, has at least one person performing services in the state, derives income from sources within the state, or directs activities at Kentucky customers for purposes of selling them goods or services.

10. Impose a tax on merchant power produced in Kentucky.

Other Tax Options

11. Calculate the state real property tax limit by excluding new property before the four percent limit is imposed.

12. Freeze the real property tax rate at the current 13.4 cents.

13. Eliminate the property tax on motor vehicles.

14. Eliminate the motor vehicle usage tax on large trucks.

15. Eliminate the deduction for income taxes paid to foreign countries.

16. Impose a tax on smokeless tobacco, cigars, rolling paper and other products not covered by the cigarette excise tax.

17. Raise the excise tax rate on cigarettes.

18. Raise the excise tax rate on beer, wine, and distilled spirits.

Telecommunications Taxes

19. Impose a revenue neutral tax rate on all telecommunications services in place of all existing state and local government ad valorem taxes on the industry. The local share could be imposed as an optional tax or could be included as part of the state rate and distributed by formula.

20. Kentucky should pass implementing legislation to move into conformity with the Federal Mobile Telecommunications Sourcing Act.

Proposals 13 and 14 reduce tax revenue. Revenue from proposals 2 through 12 and 15 through 18 could help finance these costs and result in a revenue-neutral policy. Proposal 14 reduces revenue in the Road Fund and no option replaces Road Fund revenue.

